Narragansett Electric
A National Grid Company

September 26, 2005

VIA HAND DELIVERY & ELECTRONIC MAIL

Luly E. Massaro, Commission Clerk
Rhode Island Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

RE: Docket 3689 – July 2005 Standard Offer Rate Filing

Dear Ms. Massaro:

The purpose of this letter is to address an issue that arose during the September 23, 2005 hearings related to Narragansett Electric's ("the Company") protest payments that have already been made to TransCanada. It appeared during cross-examination of Mr. Gerwatowski that a question has arisen whether such past payments are recoverable if they were not forecasted in the Company's filing with the Commission in 2004 in Docket 3648 when the current Standard Offer rate was established. The Company would like to set forth the reasons why, as a matter of law and policy, there is no retroactive rate-making bar to recovery.

The Standard Offer Reconciliation Provision

The Standard Offer rate is a fully reconciling rate. The purpose of a fully reconciling rate is to assure that all ***past*** expenses and credits are netted against all ***past*** revenues, after-the-fact. As such, the rate is estimated based on a forecast of expenses and the later reconciliation assures a precise match of costs to revenues. Because the purpose of the provision is to reconcile costs after-the-fact, the traditional rule against retroactive rate-making is not applicable to the reconciliation process.

The result would be different for a rate that is established through the use of a forecasted rate year, as is done in a full cost-of-service distribution rate case that does not include a reconciliation provision. In such event, a utility forecasts its costs, and rates are set. No reconciliation takes place. Thus, it would be retroactive rate-making if the Commission reached back to allow recovery of a past expense or required the pass back of a past credit not included in the current rate, except in extraordinary circumstances. But a reconciliation adjustment provision is fundamentally different.

The 2004 Filings

In the Company's July 2004 Standard Offer Rate Filing in Docket 3648 and its Annual Retail Rate Filing, the Company did not include in its forecast of expenses any fuel index

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payments to TransCanada for 2005. The Company did not do so because the actual terms contained in the Wholesale Standard Offer Service Agreement between the Company and TransCanada did not require such payments beyond 2004, as the Company has interpreted (and continues to interpret) that agreement. At the time of the hearings in 2004, the Company was unaware that TransCanada would take a different view and send a letter to the Company alleging default in early 2005 when no payments were made. Thus, at the time of these filings, there was no reason for the Company to include either actual fuel index payments or protest payments as expenses in its forecast. As was explained in the pre-filed testimony and at the hearing on Friday, the Company commenced making payments "under protest" in early 2005, after the current rate was set, in order to assure that TransCanada not attempt to terminate the contract.

No Bar to Recovery

An expense is not rendered unrecoverable simply because it was not included in the forecast of expenses upon which a fully reconciling rate is established. Where the tariff or law governing the recovery of such expenses contemplates or requires a reconciliation of actual past expenses incurred to actual revenues received, the forecast is merely an estimating tool – it is not a legal prerequisite to rate recovery. In this case, the expenses were actually incurred in connection with the standard offer contract. Thus, they are properly included in the reconciliation.

This is a logical result. A requirement that expenses incurred in a reconciliation period must be identified in the forecast upon which the fully reconciling rate is based would defeat the purpose of reconciliation mechanism. If all expenses or credits were required to be included in the forecast, then it would lead to a mismatch of costs and revenues, thus leading to either over or under recoveries that are not reflected in rates.

The Commission has had decades of experience with reconciling rates. It is the usual course of business that not all expenses and credits can be included in the forecast upon which a fully reconciling rate is set because not all expenses and credits are foreseeable at the time the forecast is made. A reconciling rate, by definition, begins with an estimated charge that is later reconciled to actual experience. New market rules or other events can change forecasted expenses by either adding or reducing total net costs. The reconciliation mechanism is designed to be sure that all such changes are captured in rates.

Section 39-1-27.3(b)

There is another important reason why the protest payments are recoverable, even if they were not included in the original forecast. Rhode Island General Laws specifically state that all of the company's Standard Offer revenues and costs are to be accounted for and reconciled

annually. *See* 39-1-27.3(b)[1] There is no pre-condition that the costs must be identified in advance before they are included in the reconciliation. As stated above, reconciliations are, by definition, an exercise in looking back in time to match actual costs to actual revenues. To introduce a requirement that the costs must be forecast in advance runs counter to the plain direction in the law.

Accordingly, there is no legal defect in the Company's request to include the past payments in the reconciliation account when they were not in the forecast upon which the reconciling rate was set. The Commission's past practices have allowed it, logic suggests it, and the law permits it.[2]

Important Policy Considerations

Beyond the technical rate-making rules, there is another very important policy reason why rejecting past protest payments would not be in the public interest. The Company is working very hard to manage its wholesale supply contacts diligently. A part of that process is to properly address the circumstances when disputes arise. In the case of the TransCanada dispute, the Company has not only managed the contract in good faith, but also been careful not to allow the supplier to escape its obligations prematurely. At the hearing, no party took issue with the Company's approach. The Division concurred. The George Wiley Center took no position. In fact, while TEC-RI expressed an opinion regarding the timing of recovery, at the same time, Mr. Farley's testimony encouraged the Company to aggressively pursue any other avenues that might be lawfully available to reduce costs with suppliers.

Yet, if the Commission were to make a determination that the past protest payments cannot be recovered based on a technical application of the rule against retroactive rate-making, it would not only be inconsistent with past practice and the law, but also send the wrong signal to

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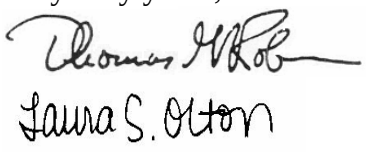
[1] The statute states, in pertinent part: "The electric distribution company's standard offer revenues and its standard offer costs shall be accounted for and reconciled with interest at least annually. Any over recoveries shall be refunded and any under recoveries shall be recovered by the electric distribution company through a uniform adjustment factor approved by the commission. The commission shall have the discretion to apply such adjustment factor in any given instance to all customers or to such specific class of customers that the commission deems equitable under the circumstances provided that the distribution company recovers any under recovery in its entirety."

[2] If the Commission finds that it is appropriate for the Company to continue making protest payments to TransCanada then, by definition, it is was appropriate for such payments to have been made prior to the hearings. As a result, it would be appropriate for such expenses (both past and future) to be included in the Standard Offer reconciliation account for recovery from customers. If, on the other hand, the Commission does not believe that it is appropriate for the Company to make any more protest payments to TransCanada, it does not mean that the past payments made are not recoverable. Rather, in such case, if the Company ceases making future payments at the direction of the Commission, it would be premature for the Commission to make any finding until the end of the litigation. That is, if a court were to find that the contract required such payments, they would be recoverable as a matter of law (in accordance with the statutory provisions). Thus, in such instance where the Commission directs the Company to cease making payments, the Commission would need to wait for the end of the litigation to determine whether the past protest payments should be recovered from customers.

the Company. In effect, the Commission would be penalizing the Company for its inability to foresee the future and include protest payments in its filing before the supplier even made any allegation of default. Such a result would be applying a standard that can only be met by persons with the ability to predict future events. Thus, instead of encouraging the Company to manage its power supply arrangements diligently to protect customers, the Commission would be providing disincentives to common sense decision-making that otherwise is in the best interest of customers.

Thank you for your attention to this matter. If you have any questions, please feel free to contact me at (508) 389-2877.

Very truly yours,



Thomas G. Robinson
Laura S. Olton

cc: Docket 3689 Service List